

APPEALS

INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE
SETTLEMENT GUIDELINES

INDUSTRY: All Industries

ISSUE: Retroactive Adoption Of An Accident
And Health Plan

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**APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE**

SETTLEMENT GUIDELINES

RETROACTIVE ADOPTION OF AN ACCIDENT AND HEALTH PLAN

IRC 105

ISSUES

1. Whether employer reimbursements under a self-insured accident and health plan for medical expenses incurred prior to the adoption of the plan are excludable from gross income by the employee under section 105(b) of the Internal Revenue Code.
2. Whether employer reimbursements under a self-insured accident and health plan for medical expenses incurred prior to the adoption of the plan are deductible by the employer under section 162(a) of the Code.

EXAMINATION DIVISION POSITION

1. Employer reimbursements under a self-insured accident and health plan for medical expenses incurred prior to the adoption of the plan are not excludable from gross income by the employee under section 105(b) of the Code.
2. Employer reimbursements under a self-insured accident and health plan for medical expenses incurred prior to the adoption of the plan may be deductible by the employer under section 162(a) of the Code even though they are not excludable from gross income by the employee.

Absent the adoption of an accident or health plan, medical expense reimbursements paid to an employee are includible in the employee's gross income under section 61.

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BACKGROUND

Employers often adopt self-insured accident and health plans to cover medical expenses incurred prior to the date of the adoption of the plan but within the same taxable year. This is done in an attempt to allow employees to exclude these medical expense reimbursements from income. Medical expenses claimed for reimbursement may include both insurance premiums and other expenses not reimbursed by insurance.

The retroactive adoption of accident and health plans often arises in situations where a self-employed business owner hires his or her spouse as an employee and seeks to cover the family's medical expenses. See, Rev. Rul. 71-588, 1971-2 C.B. 91. This arrangement is marketed through accounting firms and a national tax return preparer. Clients include self-employed persons in partnerships, limited liability corporations, subchapter S corporations and sole proprietorships. The issue may appear sporadically with respect to a particular taxpayer because business owners often choose to utilize this arrangement only during years in which substantial medical expenses are incurred.

INDUSTRY'S ARGUMENTS

Tax planners and their clients who attempt to exclude retroactive reimbursements from the income of the employee argue that these payments are made under an accident and health plan. They argue that as long as the employee's right to benefits under the plan is enforceable, pursuant to the regulations, reimbursements for medical expenses incurred prior to the adoption date of the plan qualify for the section 105(b) exclusion.

Section 1.105-5(a) of the regulations states in pertinent part:

Section 105(e) provides that for purposes of section 104 and 105, amounts received through an accident or health plan for employees. . . shall be treated as amounts received through accident or health insurance. In general an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness . . . An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights under the plan be enforceable. However, if the employee's rights are not enforceable an amount will be deemed to be received

under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the affect of plan) providing for the payment of amounts to employee in the event of personal injuries or sickness and notice or knowledge of such plan was reasonably available to the employee....

This regulation has been read by tax planners and their clients to mean that if an employee's right to payment is enforceable, there is no requirement that either a plan be in effect at the time the medical expenses are incurred or that the employee have notice of the plan. Under this interpretation of the regulation, the section 105(b) exclusion would apply.

Examination's Rebuttal

Section 105 does not address the retroactivity issue. One court has interpreted this regulation and rejected the argument of the tax planners and their clients. The court stated the following with regard to this argument:

An equally plausible reading is that by definition, an enforceable plan would be in writing and communicated to employees whereas an unenforceable plan would be ad hoc by definition (and therefore potentially arbitrary) unless the custom or practice of paying medical expenses had been in effect and made known to employees before they became ill, not just before they incurred medical expenses. Another possibility is that the focus of the regulation is on the "notice" requirement. If rights are enforceable, the employer's commitment to the plan is clear, if the rights are unenforceable, notice is required in order to ensure that payments are being made in fact "under an accident or health plan." See § 105(e)(1). . . . American Family Mutual. Ins. Co. v. United States at 1212.

Tax planners and their clients have failed to cite any decision holding that a retroactive plan is valid. Moreover, the cases in this general area evidence a concern for preventing discriminatory treatment through ad hoc, arbitrary payments of medical expenses. See, Lang v. Commissioner, 41 T.C. 352 (1963); Seidel v. Commissioner, 30 T.C.M. 1021 (1971); Smith v. Commissioner, T.C. Memo. 1970-243.

LEGAL DISCUSSION AND ANALYSIS

ISSUE 1:

The basic tenet of income taxation is that unless wages, benefits or other income fall within an explicit exclusion to the Internal Revenue Code's definition of gross income, they are included within that term. I.R.C. sections 61, 105. Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955). Exclusions and exemptions from income are matters of legislative grace and are construed narrowly. Lima Surgical Association v. United States, 944 F.2d 885, 888 (Fed. Cir. 1991); Weingarden v. Commissioner, 825 F.2d 1027, 1029 (6th Cir. 1987).

Section 105(a) of the Code provides that, generally, amounts received by an employee through accident and health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

Section 105(b) of the Code provides an exception to the general rule of inclusion under section 105(a). Section 105(b) states that gross income does not include amounts paid, directly or indirectly, to the employee to reimburse the employee for expenses incurred by him, his spouse or dependents for medical care.

Section 105(e) provides that amounts received under an accident or health plan for employees shall be treated as amounts received through accident or health insurance under sections 105(a) and (b).

Accordingly, because self-insured medical expense reimbursement plans are treated as accident and health insurance under section 105(e), medical expense reimbursements paid under such plans are excludable from the employee's gross income under section 105(b). However, section 105(b) does not apply unless the medical expense reimbursements are received under an accident or health plan.

Section 1.105-5(a) of the Income Tax Regulations states that an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. An accident or health plan must cover one or more employees, may be insured or noninsured, need not be enforceable and need not be in writing.

However, in order for there to be a plan, the employer must be committed to certain rules and regulations governing payment. These rules must be made known to employees as a definite policy and must be determinable before the employee's medical expenses are incurred. Lang v. Commissioner, 41 T.C. 352 (1963); Smith v. Commissioner, T.C. Memo.

1970-243; American Family Mutual Ins. Co. v. United States, 815 F.Supp. 1206 (W.D. Wis. 1992) and Rev. Rul. 71-403, 1971-2 C.B. 91.

In American Family Mutual Ins. Co., the employer established a flexible compensation plan which had two benefits: a medical reimbursement plan and a dependent care assistance plan. The plan was established in November and was made retroactive to January 1 of that same year. The employer's employees were reimbursed for expenses incurred from the beginning of the year and thus, before the existence of the plan. The Service asserted employment tax liability on the reimbursements which should have been treated as wages rather than nontaxable amounts.

The District Court held that the benefit plan did not meet the statutory requirements for exclusion from gross income and reimbursements therefore constituted taxable income to the employees. The Court went on to conclude that the retroactivity feature of the employer's medical benefits plan and dependent care assistance plan caused the plans to fail compliance with sections 105 and 129, respectively.

The Service's position is that payments for reimbursement of medical expenses incurred prior to the adoption of a plan are not paid or received under an accident or health plan for employees. Thus, these amounts are includible in the employee's gross income under section 61 and are not excludable under section 105(b) of the Code.

ISSUE 2:

For purposes of deductibility of accident and health expenses, section 162(a)(1) of the Code provides that a taxpayer may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 1.162-7(a) of the regulations provides that there shall be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

Section 1.162-10(a) of the regulations provides in part that amounts paid or incurred within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare

or similar benefit plan (other than deferred compensation plans referred to in section 404 of the Code) are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business.

Accordingly, **whether the payment is under an accident or health plan is not determinative for purposes of deductibility under section 162(a)**. As long as the expenses are **ordinary and necessary business expenses** (for example, reasonable compensation for services actually rendered) they are deductible under section 162(a). Thus, payments, which are not excludable under section 105(b) by employees, may nevertheless be deductible by the employer under section 162 of the Code.

SETTLEMENT GUIDELINES

ISSUE # 1

- I.R.C. § 105(b) does not apply unless the medical expense reimbursements are received under an accident or health plan.
- Absent an accident or health plan, medical expense reimbursements paid to an employee are includible in the employee's gross income under I.R.C. § 61. They are not excludible under I.R.C. § 105(b).
- In order for there to be a plan, the employer must be committed to certain rules and regulations governing payments. These rules must be made known to employees as a definite policy and must be determined before the employee's medical expenses are incurred. Lang v. Commissioner, 41 T.C. 352 (1963); Smith v. Commissioner, T.C. Memo. 1970-243; American Family Mutual Ins. Co. v. United States, 815 F. Supp. 1206 (W.D. Wis. 1992) and Rev. Rul. 71-403, 1971-2 C.B. 91.
- An accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. The plan may be insured or noninsured, need not be enforceable and need not be in writing.
- Benefits must be paid under an accident and health plan that was either in writing at the time the medical expense was incurred or was an unwritten accident and health plan of which the employee knew or should have known at the time the expense was incurred.

Wollenburg v. United States, 75 F. Supp. 2d, 1032 (D. Neb. 1999) and American Family Mutual Insurance Company, 815 F. Supp. 1206 (W.D. Wis. 1992) were successfully litigated by the government. Both cases held that medical expenses incurred prior to the adoption of a plan, either written or unwritten, may not be viewed as being paid or received under an accident or health plan for employees.

Consider all facts and circumstances in cases where an adopted plan document is not available and the effective date is in question. When and how did the employer notify employees? Were the plan provisions provided to employees?

Based on facts provided, a determination is to be made as to whether the plan was retroactively implemented or not.

ISSUE # 2.

- I.R.C. § 162(a)(1) provides that a taxpayer may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.
- Treas. Reg. § 1.162-10(a) of the regulations provides in part that amounts paid or incurred within the taxable year for benefits other than deferred compensation plans referred to in I.R.C. § 404, are deductible under I.R.C. § 162(a) if they are ordinary and necessary.
- For purposes of deductibility under I.R.C. § 162(a), whether the payments are made under an accident or health plan is not determinative. If payments are ordinary and necessary expenses of the trade or business, they are deductible.
- Thus, even if payments are not excludible under I.R.C. § 105(b) by employees, those payments may nevertheless be deductible by the employer under I.R.C. § 162.

Summary

Pending the outcome of further litigation no concession of the I.R.C. § 105(b) issue by Appeals would be appropriate when the plan is adopted with a retroactive effective date. When a plan document is available, the effective date is the date such a plan is adopted unless there was a custom and practice of payment in effect and made known to the employees before the employee incurred the medical expenses.

IRM 8.7.1.6 explains the approval procedures for appeals officers and team chiefs. Also, Delegation Order # 247 requires examination case managers to obtain the approval from both Exam & Appeals Specialists.